United States General Accounting Office

14C582

GAO Testimony

For Release
on Delivery
Expected at
1:30 E.S.T.
Monday
March 19, 1990

Activities of Securities Subsidiaries of Bank Holding Companies

Statement of
Richard L. Fogel
Assistant Comptroller General
General Government Programs

Before the
Subcommittee on General Oversight and Investigations
Committee on Banking, Finance and Urban Affairs
House of Representatives

GAO/T-GGD-90-21

Activities of Securities Subsidiaries of Bank Holding Companies

SUMMARY OF STATEMENT BY
RICHARD L. FOGEL
ASSISTANT COMPTROLLER GENERAL

GAO is testifying today on its recent report[1] about the securities activities of bank holding companies. Since 1987, the Federal Reserve has authorized 21 U.S. bank holding companies and 5 foreign banks to establish securities subsidiaries known as Section 20 subsidiaries. These subsidiaries, created in accordance with Section 20 of the Glass-Steagall Act, represent a further breach in the wall traditionally separating banking and certain aspects of securities activities established by that act.

In the third quarter of 1989, the 13 active Section 20 firms underwrote a total of about $69 billion in newly authorized securities. Almost all of this amount was commercial paper. It is, however, too early to draw conclusions about Section 20 firms' benefits, profitability, riskiness and impact on the market, or about the long-term effectiveness of the regulatory system in which the firms operate.

GAO believes there are positive aspects of the Section 20 arrangement. The limited expansion of securities activities allowed under the arrangement has been accompanied by corresponding changes in regulatory and supervisory controls. This contrasts sharply with the experience in the thrift industry where many firms expanded rapidly into new activities and federal and state regulators failed to exercise adequate supervision.

GAO has not concluded that Section 20 companies are necessarily the best long-term way of associating banking and securities activities. Issues Congress and federal regulators need to consider include

-- Whether the securities activities of a bank holding company should be more or less independent from insured banks than is now required under the Section 20 arrangement.

-- Whether the regulatory burden of so-called firewalls imposed on Section 20 subsidiaries should remain or be relaxed.

-- Whether U.S. banking organizations should have more or less flexibility in undertaking securities activities abroad than in the United States.

---

[1]Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies, (GAO/GGD-90-48, Mar. 14, 1990).

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here to discuss the securities activities of bank holding companies.

My testimony is based on our recent report prepared at this subcommittee's request.[1] I will first discuss some of the operating characteristics of securities affiliates of bank holding companies. Then I will discuss several issues associated with expanding banking organizations' securities powers that need further attention from the Congress and banking and securities regulators.

Since 1933, member banks of the Federal Reserve System have been prohibited under the Glass-Steagall Act from underwriting and dealing in securities other than what are called bank-eligible securities, which are mainly government securities. The separation of banking and certain aspects of the securities business that is required by the Glass-Steagall Act has been a central feature of U.S. financial market regulation. But in recent years, this separation has been breaking down due to changes in technology, markets, and regulation. One of the most significant of the regulatory changes is the 1987 Federal Reserve authorization of so-called Section 20 subsidiaries of bank holding companies.

---

[1]Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies, (GAO/GGD-90-48, Mar. 14, 1990).

ACTIVITIES OF SECTION 20 COMPANIES

Since 1987, the Federal Reserve has approved the applications of 21 U.S. bank holding companies and 5 foreign banks to underwrite and deal in otherwise bank-ineligible securities in wholly-owned, nonbanking subsidiaries. Activities in bank-ineligible securities have been, for the most part, limited to commercial paper, municipal revenue bonds, mortgage-backed securities, and asset-backed securities. However, 7 of the subsidiaries (5 domestic and 2 foreign) have also been authorized to underwrite corporate bonds and, after the management systems have been approved by the Federal Reserve, corporate equities as well.

These subsidiaries are called Section 20 subsidiaries because they were created in accordance with that section of the Glass-Steagall Act. Under Section 20 of the Act, a member bank's affiliate can participate in otherwise impermissible securities activities so long as the affiliate is not principally engaged in those activities. The Federal Reserve has interpreted the "not principally engaged" clause to mean that not more than 10 percent of the revenues of Section 20 companies can be derived from otherwise bank-ineligible activities. Most banking organizations have established Section 20 subsidiaries by moving bank-eligible securities activities out of the bank or other holding company subsidiaries. This has been done to provide a large enough base of revenue to make doing the bank-ineligible business worthwhile.

In authorizing Section 20 companies, the Federal Reserve established a number of special restrictions, often called firewalls, to ensure that the Section 20 company is operated independently of the banks owned by the holding company. These firewalls, which include separate capitalization and prohibitions on certain types of transactions, are summarized in Figure 1.

Operating characteristics

As of September 30, 1989, 13 of the then 21 bank holding companies with approved Section 20 subsidiaries had initiated operations involving the newly authorized bank-ineligible securities activities. Six of the 13 subsidiaries had been doing bank-ineligible activities less than 1 year. Appendices I and IV of our report provide considerable information on the activities of Section 20 subsidiaries since their creation. Among the more significant results, during the third quarter of 1989

-- The 13 Section 20 firms underwrote a total of about $69 billion in bank-ineligible securities, with commercial paper representing about 98 percent of the amount underwritten.

-- The 13 firms accounted for about 2 percent or less of the total market for underwriting municipal revenue bonds,

mortgage-backed securities, and asset-backed securities. (Comparable market share data is not available for commercial paper.)

-- Less than 2 percent of the total revenue for the 13 firms was from bank-ineligible activities.

It is too early to draw conclusions about Section 20 firms' benefits, profitability, riskiness, impact on the market, or the adequacy of the regulatory system within which they operate. However, when activities of Section 20 companies in both bank-eligible and bank-ineligible securities are considered, the firms already constitute a significant, though by no means dominant, segment of the securities industry. Section 20 companies accounted for about 7 percent of all revenue realized by SEC-registered securities firms in the second quarter of 1989 (the latest quarter for which data is available). These firms also accounted for about 4 percent of total securities industry capital as of June 30, 1989. Ranked by capital, 3 of the top 25 and 6 of the top 50 securities firms in the Nation are Section 20 firms.

ISSUES WARRANTING ATTENTION AND FURTHER STUDY

In an earlier report on issues related to repeal of the Glass-

Steagall Act, we concluded that if the securities powers of banks were to be expanded (whether by an act of Congress or by regulation), a phased approach should be used.[2] We envisioned this approach as one in which authorization of new securities activities by banking organizations is done incrementally and in a controlled manner as needed regulatory changes were put in place. The actions taken by the Federal Reserve in allowing limited expansion of securities activities in Section 20 companies have been generally consistent with the kind of approach we suggested. This contrasts sharply with the experience in the thrift industry where many firms expanded rapidly into new activities and federal and state regulators did not exercise adequate oversight or supervision.

Although we believe that the approach that the Federal Reserve has followed is a reasonable way to proceed in allowing expanded securities powers for banking organizations, we have not concluded that it is the best long term arrangement for associating banking and securities activities. In this regard, our report discusses a number of issues pertaining to the Section 20 arrangement that we think deserve serious consideration. I would like to discuss several of these issues in the remainder of my testimony.

2<u>Bank Powers: Issues Related to Repeal of the Glass-Steagall Act</u>, (GAO/GGD-88-37, Jan. 22, 1988).

Holding Company and Regulatory Structure Issues

As I pointed out earlier, in order to provide maximum separation from insured banks, the Federal Reserve chose to require that a Section 20 securities company be set up as an independent, non-bank subsidiary of the holding company. This organizational arrangement is illustrated in Figure 2.

There are, however, some problems associated with the arrangement. One reason advanced for allowing Section 20 companies to engage in securities activities is the intention to strengthen banking organizations. However, to the extent that government securities and other profitable activities are moved out of the bank to provide a base of eligible revenue for the Section 20 subsidiary, it follows logically that the bank itself becomes smaller, less diversified, and perhaps less profitable. Moreover, if Section 20 companies prove to be profitable, funds sent to the holding company parent may not be available to a bank subsidiary if the parent decides not to so invest them. Thus, while creation of Section 20 companies may enhance the profitability of the entire organization, it is not clear how the bank itself will be strengthened by this arrangement.

To avoid these problems, the OCC and some banking trade associations have recommended that the Section 20 company be set up as a subsidiary of the bank itself. As a bank subsidiary,

all Section 20 profits would pass directly to the bank, thereby strengthening the bank. Furthermore, the value of the securities firm would be consolidated with the bank were the bank to fail, thereby potentially limiting losses to the federal insurer of deposits in the bank. By the same token, however, if the Section 20 firm is a bank subsidiary, losses in that subsidiary would also pass immediately to the bank, reduce its capital, and in extreme cases, perhaps cause the bank to fail. Finally, as a bank subsidiary, a Section 20 company would be more closely linked to the federal safety net provided by deposit insurance and Federal Reserve discount loans. Extension of the federal safety net in this way may convey unwarranted competitive advantages to Section 20 firms associated with banks.

We believe there are benefits associated with using bank holding company subsidiaries as the way to expand the securities powers of banks, at least in the near term. This arrangement provides for functional regulation of the banking and securities affiliates by a federal bank regulator and the SEC, respectively. It also provides for regulation by the Federal Reserve of the financial holding company that owns the bank and securities firm, which results in oversight of all relationships between the parent and its subsidiaries.

We have not reached conclusions about how extensive regulation of the entire holding company needs to be, but its focus needs to

include maintaining the integrity of the bank's capital and assets, thereby protecting the deposit insurance fund. The Federal Reserve has a source of strength policy, incorporated in its Regulation Y, that a bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks. However, the exact conditions under which a bank holding company can be required to use nonbanking assets to support bank subsidiaries have not been set out in detail. We believe that clarification of policy in this regard is called for.

Regulatory Burden and the Effectiveness of Firewalls

A number of banking officials we talked to commented that many of the firewalls represent what can be termed regulatory "overkill." They said that the firewalls sharply reduced the benefits to customers and to banking organizations. The officials also said the firewalls were not needed because enforcement of basic banking and securities laws, such as those dealing with transactions within a holding company and conflict of interest situations, provide sufficient protection against risks or abuses.

Although we favor looking carefully at the purpose, effectiveness, and cost of each firewall, we think a cautious approach to relaxing firewalls is warranted. Firewalls provide regulators another set of tools for dealing with risk management

and conflict of interest problems that can arise when banking organizations expand their securities operations. The special firewall provisions associated with Section 20 firms limit the scale of new activities and establish prohibitions that regulators can enforce relatively easily. When individual bank holding companies can demonstrate adequate capital, effective internal controls, and ability to manage new powers in a responsible manner, consideration can be given to relaxing some of the special firewalls.

Differences in Treatment of Domestic and International Banking Operations

Another issue that needs to be considered is the differing regulatory treatment accorded domestically versus internationally based operations of U.S. banking organizations. U.S. banking organizations operate in countries, such as Germany, that do not observe the same separation of banking and securities activities as is mandated in the United States. In these countries, subsidiaries of U.S. banks (as well as U.S. bank holding company subsidiaries) can engage in securities operations within the limits set by host country regulators and the Federal Reserve, primarily under its Regulation K.

The difference between the domestic and international treatment of the securities activities of U.S. bank holding companies is illustrated in Figure 3. This figure shows the domestic and foreign operations of a hypothetical U.S. bank holding company whose Section 20 subsidiary is eligible to underwrite corporate debt. Foreign operations are bordered by dashed lines. All organizational entities that are authorized to underwrite corporate debt securities are marked with a star.

As depicted by the shaded area in Figure 3, the Federal Reserve permits unrestricted transactions (including sale of assets and extensions of credit) between the bank and its foreign branches and subsidiaries and domestic branches and nonbank subsidiaries. However, transactions between organizational units within the shaded area and other parts of the holding company that lie outside the shaded area are subject to controls under Sections 23A and 23B of the Federal Reserve Act. Section 23A imposes restrictions on the type and amount of transactions of the bank and its subsidiaries with affiliates within the bank holding company, and Section 23B requires that such transactions be on an arm's length, fair market price basis. In addition, transactions between the Section 20 subsidiary and components of the holding company (both inside and outside of the shaded area) are restricted by the special firewalls that the Federal Reserve imposes as a condition for operating a Section 20 subsidiary.

As shown in figure 3, the Section 20 firm is the only organizational unit eligible to underwrite corporate debt in the U.S. market. By contrast, 5 foreign organizational units can underwrite corporate debt in foreign markets, and transactions between 3 of those organizational units (marked with a star in the shaded area) and their parent U.S. bank, are neither subject to Sections 23A and 23B of the Federal Reserve Act, nor the Federal Reserve firewalls.

Allowing U.S. banks operating overseas to combine banking and securities activities in a manner not possible in the U.S. allows them to be competitive in overseas markets. However, we see no reason to assume that securities activities in foreign markets are any less risky than in domestic markets. Furthermore, the overseas arrangements appear to involve links between securities and banking activities that have been considered to be a potential risk to the bank and its deposit insurer in domestic markets. Perhaps, for competitive reasons, we have to apply different standards to banks' securities activities in U.S. and foreign markets. But the potential risks associated with applying different standards need to be looked at very carefully.

It is also possible that firewalls intended to protect domestic banks could eventually make it harder for U.S. banking organizations to compete with foreign ones. In its January 1990 Order authorizing 3 foreign banks to establish Section 20

subsidiaries, the Board tried, to the extent possible, to apply the firewalls to the foreign-owned banks' Section 20 subsidiaries. However, the firewalls do not all apply to these firms in exactly the same way because foreign banks generally are not organized under the same type of holding company structure that is common in the U.S., and there are limits to the restrictions which the Board can impose on the structure and behavior of foreign banks and their subsidiaries. To an unknown extent, therefore, foreign banking organizations may have greater flexibility than do domestic ones in coordinating the U.S. based activities of their Section 20 firms with other activities of the banking organization. We are pursuing these international issues in our work on deposit insurance reform and other work related to financial modernization issues.

This concludes my prepared statement. My colleagues and I would be pleased to answer any questions the subcommittee may have.